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Chapter Author: Robert S. Dohner, Ponciano Intal, Jr.

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the tradable goods sector. Despite the large devaluations, the real exchange rate at the end of 1985 was nearly unchanged from its level in the early 1980s. Beyond the income loss and unemployment, the severity of the credit squeeze traumatized the financial and industrial sectors, forcing many firms under and undermining the willingness of the banking system to take on lending risk, factors that would later delay the recovery of confidence and investment.

## 8 The Aquino Government and Prospects for the Economy

The “New Society” proclaimed by Marcos in the early 1970s failed to produce its promised improvements in the welfare of Filipinos, and, as martial law continued, opposition to the Marcos government grew. The oil shock and subsequent fall in commodity prices hurt incomes, particularly in the rural areas. Although measured economic growth was substantial, regional income disparities increased, and over the decade the proportion of the population living in poverty remained high.<sup>1</sup> Continuing arrests and human rights violations by the military brought protests, particularly from the Catholic church.

But the most crucial loss of regime support came in those groups that had provided the initial constituency for martial law. The patronage machinery on which the political foundations of martial law rested, especially the particularistic interventions and the generation and distribution of monopoly rents, tended over time to narrow the base of political support. By 1985 Marcos’ base was dangerously thin.

The early support for the government within the rural sector faded as the momentum of land reform dissipated and as military abuses and corruption increased. Even though agricultural terms of trade were falling, the government increased its taxation of important crops through export and producer levies and through monopolization of trading and processing activities. The increasing incidence of rural poverty aided the insurgency, and the communist NPA took over effective administration, including taxation, in several areas.

Although the military had been the main beneficiary of martial law, opposition within the armed forces developed over promotions and over the deployment of forces against the Moslem and communist insurgencies. Before 1972, the Philippine armed forces had been small, relatively professional, and reasonably effective. Martial law greatly expanded the size

of the military, politicized its command structure, and greatly increased the opportunities for personal gain. Loyalty and close association to the president, or to his wife, became the primary criterion for advancement within the services, and Marcos filled the highest posts with officers from his home province, Ilocos Norte, skipping over other officers in the ranks. Elite forces were created to protect the presidential palace, and military resources generally were concentrated in and around Manila. The path to advancement was through the capital; less favored personnel engaged in the war against the communist and Moslem insurgencies, mostly in badly led and ineffective operations. Soldiers in the field were poorly equipped and supported. In many cases they were forced to live off the population, adding to popular grievances toward the military.

The business sector benefitted under martial law from restraints on labor organizing, the rapid rate of public investment, and the continuing protection of the manufacturing sector. Yet by 1985 the private business sector had almost completely deserted Marcos, prominent industrialists were outspoken critics of the regime, and white collar workers in the financial district in Makati were protesting against the government. The particularistic interventions that had favored associates of the regime, the creation of monopoly positions, and the aggressive takeovers through threat of ruin alienated increasing numbers of businessmen. Many sought accommodation with Marcos; more transferred capital beyond the government's reach. The corporate bailouts of the early 1980s spurred protests from some in the business sector, and there was cautious, although increasing, opposition to the government.<sup>2</sup> Marcos' deteriorating health, the undefined succession mechanism, and the possibility that his death would lead to a seizure of power by his chief of staff, General Fabian Ver, or by his wife, Imelda, added to business unease.

In order to diffuse some of the internal opposition to him and pressure from the United States, Marcos instituted political reforms in a carefully controlled fashion. Martial law was officially lifted in 1981, although Marcos retained his ability to rule by decree. Presidential elections were held in that year, although the opposition refused to field a candidate in an election that Marcos controlled. A legislature, the *Batasang Pambansa*, was created and elections were held in 1983. The elections were also carefully controlled, although opposition parties did field successful candidates. The *Batasang* was subordinate to the president; Marcos could overrule any act of the legislature and could dissolve the body if he wished.

But it was the assassination of Benigno Aquino on his return from exile in the United States that changed the political atmosphere in the Philippines and brought continuing and widespread public protests and opposition to the Marcos regime. Political violence was by no means unknown in the Philippines and had characterized the local electoral process. But the killing of Aquino, the most prominent of the opposition figures, as he was being

escorted by military guard from the airplane on which he arrived, was such a shocking transgression that it irrevocably altered the public view of the regime. For the first time, the Manila upper and middle class felt physically threatened by the Marcos government.

In the end Marcos also lost his external support. The attitudes of the IMF toward the Philippines changed markedly after the reserves overstatement discovery and the explosion in the money supply in the last half of 1983. The Fund imposed stringent conditions in the stabilization program, including a drastically reduced deficit target for 1985. The Fund also pressed hard (although unsuccessfully) for reforms in the sugar and coconut industry, threatening vital remaining Marcos constituencies. The World Bank took a somewhat more sympathetic view, but its funding declined sharply after 1983.

More important for the maintenance of power in the Philippines was the shift in attitudes of the United States. U.S. relations with the Philippines had improved considerably with the inauguration of President Ronald Reagan in 1981. Vice President George Bush attended Marcos' inauguration after the 1981 presidential election, Marcos visited the United States in 1982, and Reagan had planned a visit to the Philippines in 1983. The Aquino assassination and the growing protests in the Philippines and the United States against the Marcos government played a role in shifting the U.S. position. But it was the growing strength of the NPA that was in the end decisive, convincing even conservatives in the U.S. government that Marcos had become a liability and that fundamental reforms would have to take place in the Philippines.

Despite mounting domestic and international opposition, Marcos remained a master of Philippine politics, constantly keeping his opponents off balance and exploiting the divisions among the opposition parties. In November 1985, in an attempt to diffuse pressure from the United States, Marcos called a snap election for 7 February 1986, counting on the divisions within the opposition and his control of the electoral process to assure an easy victory. He erred on both counts. The two major opposition groups were able to unite on Corazon Aquino, the wife of the slain opposition leader, as a presidential candidate, when Salvador Laurel, the leader of the other group, agreed to join her ticket as the vice presidential candidate.<sup>3</sup> The Marcos political machine, which had served so well in the previous twenty years, either deserted him or proved unable to deliver. Marcos won the official election count, but only through blatant and extensive fraud that was evident to the numerous foreign observers who had gathered in the Philippines for the election.

In the weeks that followed, the opposition refused to accept the official election results and publicly called for Marcos to step down. Opposition party members organized protests and called for a boycott of financial institutions that were associated with the Marcos government, leading to large deposit withdrawals from several government banks.

The breaking point came on February 22, when Marcos' defense minister, Juan Ponce Enrile, along with General Fidel Ramos and a small number of troops, set up a command post at the Manila army base Camp Crame and declared their support for Corazon Aquino. The failure of Marcos and his chief of staff, General Ver, to quickly move against the rebels, the mobilization of huge numbers of civilians to surround and physically block loyalist troops from entering Camp Crame, and an eventual flood of defections from government forces left Marcos, by the time of his inauguration on February 25, a virtual prisoner in Malacanang palace.<sup>4</sup> He left the Philippines the next day on a U.S. Air Force jet for Guam and then to exile in Hawaii. On 26 February 1986, Corazon Aquino was suddenly president of the Philippines, in an unexpected and uneasy alliance with the military.

The presidential election and its immediate aftermath had a significant impact on economic policy. The fiscal and monetary discipline that the Philippines had exercised under its standby arrangement with the IMF was abandoned to the cause of electoral survival. At the end of the third quarter in 1985, the Philippines was well within targets for the money supply, but between October and mid-February the money supply grew by over 50 percent, reaching a level of P. 44 billion, well above the March 1986 program target of P. 39 billion. The government deficit ballooned to P. 10 billion in the first quarter, ten times the deficit of the first quarter of 1985 and more than the program target for the entire year.

After the election, the central bank sought to rein in the money supply to meet the IMF program requirements. The central bank's efforts were complicated by the opposition-inspired boycott of government-associated financial institutions which severely affected several commercial banks, particularly the Philippine National Bank, and required a sharp increase in emergency assistance. But the central bank persisted in selling its own securities, and by the end of June the money supply had been reduced by 13 percent to P. 38.0 billion. The result was a further domestic financial shock—Treasury bill rates rose from 16 percent in January to 24 percent in February, at a time when inflation was decelerating. Real interest rates on commercial bank loans reached 30 percent in the same period. The stringent monetary actions prevented the injection of funds during the election campaign from translating into higher inflation or currency depreciation, but those gains had a high price. Real investment fell by an additional 15 percent in 1986, and the episode further unsettled an already skittish financial system.

## **8.1 Challenges Facing the New Government**

Despite the mood of national euphoria that accompanied Corazon Aquino's assumption of the presidency, the problems that her government

faced were extremely difficult ones, involving both political and economic reconstruction. The Marcos regime had corrupted and nearly destroyed key Philippine institutions. The military had become highly politicized, intimately involved in government, and accustomed to the patronage flows that martial law had created. Public esteem for the armed forces had almost disappeared. So had the effectiveness of the military as a force in countering the communist insurgency; in 1986 the NPA was far better organized and more capable of mounting operations than were the Armed Forces of the Philippines. However, despite its weakness in the field, the military remained a potent force in Manila politics, and its crucial role in precipitating the collapse of the Marcos government convinced many in the defense establishment that their position was coequal with that of the new president.

The Philippine judiciary had also suffered under martial law. The ability of Marcos to dismiss judges at any level bent the judiciary into cooperation. Judicial decisions were increasingly based on influence or on wealth during the latter years of the regime. Other democratic institutions had been greatly weakened. The 1973 constitution had been molded to assure Marcos' hold on government and had been repeatedly amended by him to suit immediate needs. The *Batasang Pambansa*, the legislature that Marcos created, had no substantive authority and was controlled by members of Marcos' party, the *Kilusang Bagong Lipunan* (KBL). Political power and almost all decision making had been centralized in Manila under martial law; local governments had in some cases been superceded by the military, and the administrative ability of provincial and local governments weakened.

Political issues and events dominated President Aquino's first two years in power. The new government moved immediately to dismantle the political structures that Marcos left behind. Aquino dissolved the Marcos-controlled legislature. She dismissed thousands of local governors and mayors, replacing them with officers in charge, who would serve until elections could be held. The new government also moved quickly to recapture the assets that Marcos and his cronies had accumulated during the previous administration. Aquino's first executive order established the Presidential Commission on Good Government (PCGG) to pursue legal action against Marcos and his associates outside the Philippines, and to identify and sequester their assets in the Philippines.

Next was the need to provide a legal framework for the new government, and to begin to rebuild the institutions that had deteriorated or been destroyed by martial law. In March 1986 Aquino declared a "Freedom Constitution" that gave her the decree-making powers of her predecessor, although for a limited period, included a bill of rights, and called for a convention to draft a new constitution. The convention produced a draft constitution that was approved in a national referendum in February 1987. The constitution provided for a legislature similar to the U.S. Congress, and

congressional elections were held in May 1987. Local elections for mayors, governors, and other officials were held in January 1988, completing a process of four national referendums in just under two years.

The other political challenge the Aquino government faced was assuring its own survival. Early coup attempts were mounted by Marcos loyalists. Later, more serious attempts were mounted by members of the armed forces, first in November 1986 and then in August 1987, in a coup that almost toppled the government. The military grievances against the government were several. The first concerned the national reconciliation policy that Aquino had adopted to deal with the Moslem and communist insurgents. The low pay and lack of support and equipment for military personnel also fueled discontent. Furthermore, military officers viewed themselves as political participants; some of the same individuals who had first deserted Marcos in February 1986 were the ones who led the coup attempt in August 1987.

The partnership between the military and the Aquino government remains uneasy, and the military itself is highly factionalized. The Aquino government moved to satisfy some of the demands of the military after the August coup attempt, adopting a firmer stance toward the communist insurgency, increasing military pay, and removing from the cabinet members of whom the military had been especially critical. But Aquino was also forced to co-opt the military leadership, appointing and promoting on the basis of loyalty to the new government, and this has increased resentment in some quarters and set back the process of professionalizing the armed forces. While the NPA is a more serious threat to the security of the country, the military remains a more immediate threat to the elected government.

The Aquino government also faced serious economic problems, as well as exaggerated expectations about what a new government could accomplish in the economic sphere. The recession of the previous three years had led to a sharp fall in per capita income, erasing the fruits of the previous eight years of growth. Open unemployment in Manila had doubled to 22 percent, while rates of underemployment were estimated at 40 percent. The import-substituting industrial sector had been decimated by the recession, with production cuts in some industries as high as 80 percent. Real investment dropped by over half between 1983 and 1986, but substantial excess capacity and continued financial and political uncertainty limited its recovery.

The Philippines also faced the burden of the external debt inherited from the previous administration. At the end of 1985 total external debt of the Philippines was \$26.3 billion. Although the total had only increased by 6 percent in the previous three years, the ratio of Philippine external debt to GNP had jumped from 63 to 82 percent, the result of declining economic activity and the real depreciation of the peso. Net external borrowing was almost zero for 1986, but the total external debt jumped again to \$28.3 billion. This was the result of the appreciation of the yen against the dollar during the year and the fact that about 15 percent of Philippine external debt

was denominated in yen. By the end of 1986, the debt/GNP ratio had risen to 94 percent, placing the Philippines among the most heavily indebted less developed countries.

The 1985 rescheduling had reduced the immediate debt service burden, but in 1986 external debt service still absorbed 34 percent of total exports of goods and services. And the limited capital inflow under the restructuring agreement meant that, with interest payments and a current account surplus, the Philippines on net was transferring resources to the rest of the world amounting to 9 percent of GNP. Furthermore, the debt rescheduling agreement was to expire at the end of 1986, which meant that the new administration had to turn almost immediately to a new round of negotiations with the country's external creditors.

As important, and more complicated, were the fiscal problems facing the Aquino government. These were especially crucial, for the fiscal constraints severely limited the government's room to maneuver and its ability to respond to strident domestic demands. The Marcos government had reduced the national government's budget deficit to 1.9 percent of GNP in 1985 (although it missed the IMF target of 1.5 percent). But the reduction in the national government deficit is deceptive. The revenue effort of the government, the share of total government revenue in GNP, had declined markedly during the 1980s, increasing the required expenditure cuts to close the budget gap. In addition, the requirements for debt service and for support of state-owned corporations and financial institutions increased dramatically from 11 percent of expenditure in 1982 to 35 percent in 1985.<sup>5</sup> The cuts came largely in government capital expenditures, which fell by more than 50 percent in real terms. But the Marcos government had also drastically reduced real outlays for operations and maintenance from levels that were already low relative to the public sector capital stock. Not only was the government not investing, it was consuming its current capital stock by neglecting maintenance. Public employment continued to expand during the stabilization period and was 11 percent (70,000 workers) higher in 1985 than in 1983. Real wages of public sector workers fell, and there were critical pressures for wage increases for teachers and soldiers.

Finally, the hemorrhaging of the budgets of the government financial institutions continued to worsen in the first year of the Aquino government, as remaining government guarantees were called and as the interest burden of central bank securities increased. It was recognized early on that transfers to financial institutions were going to increase in 1986; in fact they almost doubled, reaching P. 24.2 billion, or 23 percent of national government expenditure and 4 percent of GNP.<sup>6</sup>

The economic landscape facing the new government was not entirely bleak; there were some significant advantages that assisted the new government in its first year in office. The first of these advantages was that the Marcos government had successfully carried out the stabilization

program required by the IMF. The current account deficit had been closed, and the aggressive sale of central bank securities had reduced the inflation rate to below historical levels by the end of 1985. Thus the costs of stabilization had already been paid by the time the Aquino government came into office. The stabilization program had its weaknesses. It was more severe and costly than the situation required, and it was also pure stabilization—nothing in the program provided structural adjustments that would encourage and sustain a recovery in the future. But the achievement should not be underestimated, and its importance to the succeeding government was real.

The second advantage for the Aquino government was that, for the first time in many years, external events worked in its favor. Philippine terms of trade rose by 16 percent in 1986, the largest increase since the 1973 commodity price boom. Almost all of this improvement came from the sharp fall in world oil prices, which reduced Philippine petroleum imports by \$580 million, or 2 percent of GNP. Commodity export prices were little changed until the last quarter of 1986, when coconut prices rose sharply. World commodity prices rose strongly in 1987, and Philippine terms of trade rose by an additional 9 percent. International interest rates also slid during 1986. By the end of the year, LIBOR rates had fallen over two percentage points, saving the Philippines \$200 million in interest payments.

The Aquino government was the beneficiary of substantial international goodwill which it was able to translate into additional concessional finance. Official aid flows for 1986 came to \$1.4 billion, over twice their level in 1985, although not as large an increase as the Aquino government had originally hoped for. Additional grant funds came primarily from the United States, which increased its Economic Support Fund contributions by \$100 million, bringing the total to \$300 million for the year. Major additional loan funds came from the Asian Development Bank and Japan. The Philippines was also able to secure additional commitments for 1987 and beyond, from the Japanese, the Asian Development Bank, and from the World Bank for a \$300 million economic recovery loan.

The successful stabilization program and the end of the Marcos government's predation on the economy greatly diminished outflows through capital flight. Privately owned capital began to flow back into the Philippines in 1986 into real estate investments, the Philippine stock market, and campaigns for the congressional elections in 1987. As a result, pesos sold at a premium in the black market in Hong Kong, as residents sought to avoid the official market in Manila (see table 7.1). Personal transfers to the Philippines also increased sharply in 1986. What did not occur was a significant increase in foreign direct investment, despite the government's desire for additional foreign capital. Inward foreign direct investment flows increased from their 1985 level, but remained well below their 1981–83 average.

The final advantage that the new government had when it entered office was the general revulsion against the excesses and plunder of the Marcos government. Aquino had campaigned on a platform of reducing the role of government in business activities, doing away with particularistic grants of privilege, and returning acquired companies, as well as many government-established corporations, to the private sector. The widespread desire to purge the country of the institutions of the previous government, the desire for economic reform and recovery, and in addition, the disarray of the sectors that had depended on government protection or largess, created an opportunity for sweeping economic reforms. Although economic policy was overshadowed by political reconstruction and political crises, the government was able to push through fundamental policy changes that had long been advocated by external critics of the Marcos government.

## 8.2 Economic Policy

The Aquino government faced three types of economic policy problems. The first was short-run economic policy to achieve recovery after almost three years of recession. The second was the establishment of broad outlines of economic policy for longer term growth, while the third was a renegotiation of the Philippine external debt with official and private creditors.<sup>7</sup>

### 8.2.1 Recovery

The Philippine stabilization episode was unusual in that domestic consumption expenditure did not drop, but instead continued to slowly rise as households drew down their savings. By 1986 there was little reserve left to consumption that could be drawn on to support recovery. Investment had been decimated during the recession and dropped further in 1986, a reflection of both the high degree of political and economic uncertainty and large excess capacity in most industries. The government immediately drew up a plan of increased public expenditure to boost the economy, primarily through a Community Employment and Development Program (CEDP) for labor-intensive projects in rural areas.

The targets under the previous IMF program for the Philippines had been exceeded in the pre-election spree of the Marcos government, and the government was unable to draw on the second-to-last tranche of the standby agreement. Instead of a waiver, the government and the Fund negotiated a new standby program for the country. The atmosphere in the negotiations was far more cordial than that of the previous standby, and the resulting program was more liberal than its predecessor. The program allowed a 30 percent growth in base money from March 1986 to March 1987, the first increase in the government investment program since the crisis, and a rise in

the national government deficit from 1.9 percent of GNP in 1985 to 4.4 percent in 1986.<sup>8</sup> The new program, submitted in September and approved in October, was for \$262 million over eighteen months, with an additional \$296 million available immediately under the Compensatory Finance Facility (IMF 1986c). Although real government expenditure did increase in 1986, organizing and implementing expenditure programs was difficult for the new government. The CEDP employment program was slow in getting started, and at the end of the year disbursements lagged well behind targets. Public sector investment also came in below targets due to a shortfall in expenditure by government corporations.

### 8.2.2 Policy Reforms

The Aquino government had much greater success in implementing broad economic policy reforms. Although these took place under the shadow of political events, and not all reforms were achieved, by mid-1988 the policy environment in the Philippines had been fundamentally altered. Economic policy was more neutral in rewarding lines of economic activity, more transparent than it had been since the 1950s, and compared favorably with that of any other East Asian country.

Understanding the success of the Aquino government in shifting economic policy requires some discussion of the ideological bases of the new administration. Although the opposition to the Marcos government in 1986 covered the entire ideological range, the 1986 presidential election was contested by only a limited segment of the opposition. The two groups that united to field Corazon Aquino and Salvador Laurel as candidates were from the center to center-right of the political spectrum, a group that has been characterized as “conservative reformists” (Lande 1986, 124). This group has provided the core of the new government, despite its appearance of being ideologically fractious.

The conservative reformist nature of the cabinet was epitomized by President Aquino’s choices for the two key economics portfolios. The finance minister, Jaime Ongpin, was chairman of Benguet Mining Corporation and had also headed the citizens’ election commission, NAMFREL, in the presidential election. The central bank governor, Jose Fernandez, was the sole holdover from the previous government and had been appointed by Marcos, under pressure, after the reserves overstatement discovery. As central bank governor, Fernandez had been responsible for much of the success, and the severity, of the stabilization program.

Other cabinet ministers represented a wider range of opinions. Furthest to the left was Labor Minister Augusto Sanchez, whose pronouncements about labor justice and workers rights quickly made him the Aquino government’s *bête noire* among business groups, bankers, and U.S. officials.<sup>9</sup> More centrist, but also outspoken, was Planning Minister Solita Monsod. Monsod was strongly critical of foreign commercial banks for many of the loans that

had been extended to the Marcos government, and argued for a case by case review and "selective repudiation" when funds had been knowingly lent for corrupt or questionable projects. Within the cabinet, she has pushed for trade liberalization, land reform, and a more growth- and foreign-resource-oriented economic policy.

The last key player on economic matters was Joker Arroyo, who held the powerful office of presidential executive secretary, or "little president" as it is known in the Philippines. Arroyo pushed for a more nationalist economic policy and resisted efforts to sell off state-owned or -acquired corporations, using his control over the flow of paper to the president to sidetrack measures he opposed. Arroyo was also a harsh critic of the military and a focal point for armed forces criticism of the government. He left the government after the coup attempt of August 1987, in an arrangement that also included the resignation of Finance Minister Ongpin.<sup>10</sup>

Although the Aquino government did not have the benefit of a transition period, it was able to draw on a group of University of the Philippines academics, who had been involved in critical analysis of the Philippine economy in the latter years of the Marcos regime.<sup>11</sup> This group quickly prepared a policy agenda for the new government that became known as the "yellow book" (Albuero et al. 1986). The economic policies proposed in the yellow book were essentially conservative, market-oriented policies, many of which had long been advocated by the multilateral institutions, the United States, and other outside observers of the Philippine economy.<sup>12</sup>

The authors of the yellow book argued for greatly reduced government intervention in the economy, an emphasis on alleviating poverty and achieving distributive justice through land reform, and a reorientation of development policy toward rural areas. To support the rural-based development strategy, the yellow book recommended an outward-oriented trade policy, the elimination of quantitative restrictions on imports, the elimination of taxes on traditional exports, and the avoidance of an overvalued exchange rate. The authors argued that debt servicing should be subordinated to the goals of economic recovery and achieving growth, but they favored seeking additional external resources to sustain growth rather than reducing debt servicing costs through unilateral action.<sup>13</sup> Other recommendations included a shift in the basis of taxation toward direct taxes, the reduction of taxes on financial intermediation, and the privatization of much of the government corporate sector. The recommendations of the yellow book became the basis for economic policy under the Aquino government, although implementation of some proposals has proved difficult.<sup>14</sup>

The Aquino government was able to move quickly to dismantle the particularistic and monopolistic interventions of the martial law government. In the coconut sector, it removed the export levy and the prohibitions on direct exports of copra and new investments in milling; as a result, the spread between world and farmgate copra prices narrowed sharply. In the

sugar industry, the Aquino government abolished the Philippine Sugar Marketing Authority (PHILSUMA) and its control over domestic and export sales. A new regulatory administration was set up to allocate quotas for domestic sales and sales to the U.S. market, with the quota certificates freely tradable among producers. The government eliminated other monopolies, including those covering imports of livestock and most fertilizer.

### *Fiscal Reforms*

Within a few months of coming to power, the new government agreed on and began to implement an extensive tax reform program, with surprisingly little opposition. The program had several objectives—to raise revenues, improve the responsiveness of the tax system to economic growth, and to lower the taxation of poor families. Additional revenue came from increases in taxes on cigarettes and beer, the removal of tax and duty exemptions from publicly owned corporations, and the adoption of a uniform corporate income tax rate with limitations on allowable deductions. The elasticity of the tax system was improved by converting excise taxes to an ad valorem basis, by making tax rates more uniform and removing exemptions, and by plans to strengthen collections. Although income taxes were eliminated altogether for families below the poverty line, and all export taxes, except those on logs, were removed, the program produced a net revenue gain estimated to be P. 15 billion in 1987, or 18 percent of total tax revenues.<sup>15</sup>

The reform proposal also included measures to strengthen tax administration. The government approved plans to introduce a general value added tax of 10 percent in 1988 to replace the poorly performing sales tax system. Tariff collections by the Bureau of Customs had been well below applicable duties on Philippine imports. After considerable internal struggle, the Philippines engaged the services of a Swiss firm, Société Générale de Surveillance, to do preshipment checks on Philippine imports from selected ports to improve customs collections. The Aquino government also introduced tax amnesty provisions to encourage payment of back taxes.

The elimination of monopolies and the tax reforms were primarily administrative measures that could be carried out quickly once the new government came to power. Other problems carried over from the previous government were less easily solved. The Aquino government inherited approximately 285 government corporations and subsidiaries, many of them creatures of the Marcos government, as well as a huge burden of external liabilities and nonperforming domestic assets. In one of her first acts in office, Aquino established a Presidential Commission on Government Reorganization (PCGR) to study and make recommendations for reforms of government corporations, as well as public financial institutions.<sup>16</sup>

Under the recommendations of the commission, 125 government corporations were to be sold, 37 retained in their current form, and the remainder abolished,

consolidated or converted to regular government status (Philippines 1987, 8). Along with the reorganization proposals, the Aquino government adopted policies to rationalize and increase the transparency of government support for the corporations. Government corporations were required to pay dividends on government equity and interest on outstanding government net lending. In addition, the Philippines promised the Fund and the World Bank that it would clear up the arrears that had developed among public sector corporations and between the corporations and the national government.

The government took several steps to deal with the problems of the National Power Corporation, the largest of the public sector corporations. The principal difficulty of the NPC was the nearly completed but nonoperational nuclear power plant, and the \$2.1 billion external obligation associated with it. Various concerns had been raised about the quality of the construction in the plant and the geological safety of the site. Based on these concerns, Aquino decided against operating the plant. The nuclear power plant and its debt obligations were transferred to the national government to assist the rationalization of NPC's operations. The government also announced other reforms in the power sector, eliminating the tax and duty exemptions enjoyed by NPC and declaring that it would gradually eliminate the subsidized provision of electricity to Manila customers.<sup>17</sup>

#### *Financial Institution Reform*

The position of the two major government financial institutions, the Development Bank of the Philippines and the Philippine National Bank, was particularly acute. Almost 90 percent of the assets of DBP were nonperforming, as were well over half of the assets of PNB; in total, the nonperforming accounts came to \$7 billion.<sup>18</sup> Government budgetary support for the two institutions alone swelled to P. 16 billion in 1986, 15 percent of the budget, and 2.6 percent of GNP. National government aid to nonfinancial public sector corporations added an additional P. 11 billion. The drain on the government budget posed by the nonperforming assets of the financial institutions was an immediate concern of both the IMF and the World Bank, and became a qualitative performance requirement in the program that the new government negotiated with the IMF.

The Philippine government developed a rationalization program for DBP and PNB in 1986, with the assistance of the World Bank and support from a \$150 million economic recovery loan. Under the program, both institutions transferred their nonperforming assets to the national government, which also assumed the corresponding liabilities. The book value of the assets transferred came to P. 85 million for DBP (\$4.2 million) and P. 72 billion (\$3.6 billion) for PNB. Both institutions made substantial cuts in staff to reduce costs, and PNB closed most of its overseas branches.

The reform measures that the Philippines adopted with respect to PNB and DBP were designed to place both institutions on an equal footing with

private commercial banks. The obligations of the two institutions would no longer carry government guarantees nor would the two have access to special credit or tax privileges. Public sector deposits would no longer be available on the scale or at the low cost they previously enjoyed and, just like private commercial banks, both would be subject to external audit. In addition, the government agreed that social projects with below market rates of return would be funded through explicit budgetary support, rather than at government behest through its financial institutions.

The transfer of the assets of PNB and DBP to the national government and the government's assumption of the liabilities of the two institutions greatly reduced the share of the government in the domestic financial market.<sup>19</sup> Under the restructuring program, the government pledged to operate PNB as an ordinary commercial bank, eventually offering shares for sale to the private sector as its profitability improved. The emphasis of DBP was to shift from large-scale, industrial sector loans to the provision of credit for agriculture, housing, and small and medium-sized firms. The rationalization programs were largely successful; by 1988 both institutions were profitable. The Philippine government also pledged to sell off the six commercial banks that it had acquired.

### *Privatization*

One of President Aquino's campaign pledges was to return the corporations acquired by the government to the private sector and to sell off government corporations that duplicated private sector activities. The new government established an interagency Committee on Privatization headed by the finance minister and, as an implementing arm, the Asset Privatization Trust (APT) headed by David Sycip, a prominent local businessman. The APT was given a five-year timetable to dispose of the acquired assets; all sales were to be done in cash, with bids collected through auction.

The privatization program in the Philippine has proceeded slowly and has revealed deep ideological splits within the government. There has been widespread dissatisfaction among investors over the pace of the program, and recurring disagreements within the government over the assets that have been included or left out of the sales list. There has also been no single agency responsible for carrying out privatization. The APT has been responsible for the sale of nonperforming assets transferred to it, and these have come almost entirely from the two major government financial institutions. In contrast, the reorganization and privatization of nonfinancial government corporations has been left to the corporations themselves, and many have been reluctant participants. At the end of 1987, the APT had accepted bids for over forty assets for a total of P. 3.3 billion (\$160 million).<sup>20</sup> In these sales, the APT has been able to realize about 20 percent of book value.<sup>21</sup> But as yet none of the government corporations slated for privatization has been sold, and the status of many of the most attractive

assets that the government holds is still uncertain. Despite Aquino's reaffirmation of her government's commitment to proceed with its privatization program, the program remains in doubt.<sup>22</sup>

### *Trade and Industrial Policies*

The Marcos government had initiated a tariff reform and trade liberalization program in the early 1980s under a structural adjustment program with the World Bank. The tariff reductions were successfully completed by 1985, but little progress was made in reducing quantitative restrictions and licensing requirements. Both the tariff reform and trade liberalization programs were superseded by the balance of payments crisis in 1983, as tariff surcharges were applied and the central bank imposed foreign exchange allocation. Both the tariff surcharge and the central bank allocation of foreign exchange were removed under the IMF program in 1985. At the end of 1985, the Philippines adopted a second program of trade liberalization, covering 1,232 items subject to import licensing, but this program was interrupted by the presidential elections and by the change of government in early 1986.

Trade liberalization was among the policy proposals contained in the yellow book and was a priority of both the IMF and the World Bank in negotiations with the Philippines in 1986. Within the cabinet, trade liberalization was pushed strongly by Planning Minister Monsod. However, trade liberalization quickly became the most controversial economic policy issue facing the Aquino government. Liberalization was strongly resisted by industrial groups, represented in the cabinet by the minister of trade and industry, Jose Concepcion, as well as by several leftist groups. The government decided to continue with the 1985 program of trade liberalization, replacing the import licensing requirements with tariffs of equal protective effect. By April 1988 all 1,232 items had been liberalized, and the government was committed to liberalizing an additional 104 items by mid-1989. On the remaining items subject to licensing, the government decided to retain limits on 114 for health and security reasons, and deferred decision on the remaining 455 items subject to quantitative restraint. This last list contains many of the most sensitive products—finished consumer durables and industrial intermediates—and the IMF has continued to press for their liberalization.

The Marcos government also revamped the industrial incentive system in 1983 as a part of the structural adjustment program. The revised investment incentives made the encouragement of exports a priority, deemphasized the measured capacity concept that had been used to define overcrowded industries, and simplified and reduced the number of incentives. Investment incentives were replaced with performance-based incentives covering profits, wages paid, and the extent of domestic procurement of inputs. As a result, the capital-cheapening effect of the incentive system was greatly reduced.<sup>23</sup>

The Aquino government, after much internal debate and delay, finally issued its own set of investment incentives in the Omnibus Investment Code of July 1987. Most of the incentives system remained unchanged from the 1983 revisions. The most significant modification was the replacement of performance-based incentives on net local content and net value added with income tax holidays. In addition, the government appears to have increased the scope for discretion in administering the incentives by reviving the notion of measured capacity and reinstating an investment priorities plan. The nature of the incentive program is still under discussion with the World Bank, and a further study of the incentive system is one of the conditions of the Bank's economic recovery loan to the Philippines.

The policy reform momentum in the Philippines has, at least for the time being, waned, and policy debates over the next few years are likely to involve holding actions on reform measures that have already been taken. The Aquino government has moved much farther in some areas than in others. The fewest results have been achieved in the highly visible privatization program, which became for many investors a barometric indicator of the attitudes of the Aquino government.

The Aquino government has had more success in policies establishing the economic framework, or environment, in the Philippines. And despite varying success, one should not understate the degree of reform that has been achieved. Government intervention in many domestic markets has been greatly reduced or eliminated, monopolies and exclusive privilege have been abolished, and publicly owned firms are now on a footing similar to that of private companies. A comprehensive tax reform has been undertaken in a very short period of time. And the trade and industrial incentive reforms to which the Marcos government had committed itself have been taken up and largely completed. In the 1980s the Philippines has gone from being the ASEAN country with the most stringent import protection to a country with restrictions comparable to other East Asian countries and low by international standards, as we point out in table 8.1. A recent World Bank mission concluded that "as a result of cumulative policy adjustments since 1980, the Philippine regulatory and incentive structure has fewer distortions than at any time since 1950, and is now comparably neutral with other East Asian countries".<sup>24</sup>

### *Land Reform*

There is one further policy issue that is important both for the economic development of the Philippines and for its political stability, and that is the issue of land reform. Land reform has long been an issue in Philippine politics. In the period since independence there have been several efforts at reform, mostly confined to legislation and the creation of agencies responsible for land reform efforts. But land reform has largely been undertaken for political reasons, either to mobilize rural support or to diffuse

Table 8.1 Comparative Trade Protection, East Asian Countries

	Average Nominal Tariff	Percent of Import Items Restricted
Philippines		
1980	43	37
1986	29	17
Indonesia		
1980	28	na
1987	23	16
Korea		
1980	25	31
1985	22	12
Malaysia		
1980	12	<5
1985	14	<5
Thailand		
1980	31	<5
1985	34	<5

Source: World Bank (1987), vol. 2, p. 54, table 2.5.

rural-based conflict, and once those aims were fulfilled reform quickly subsided, being neither actively funded nor strongly pushed from the center. A case in point is the limited, although politically successful, land reform and resettlement efforts during the Magsaysay administration in the late 1950s that was instrumental in sapping the Huk rebellion, a communist guerilla movement that grew out of the resistance to the Japanese occupation.

Ironically, the most extensive, although still quite limited, land reform was carried out at the beginning of martial law, covering rice and corn lands. As on previous occasions, land reform had its political objectives: rallying rural support for Marcos' New Society and threatening the existing elite. Eventually, however, land reform was used as a way of enriching presidential associates and Marcos himself, for the martial law period also saw the most extensive land seizure and extralegal manipulation of land claims in Philippine history.<sup>25</sup>

Economic factors in the 1970s and 1980s have added to the pressure of rural land tenancy and, increasingly, of rural landlessness. Up until the mid-1960s, a growing population was absorbed by an extension of land under cultivation, particularly with resettlement in the southern, and Moslem, island of Mindanao. However, the Philippines reached the limit of further land expansion, and land densities have grown steadily since that time. The period has also seen some shifts within the agricultural sector to high value crops, generally crops that require less labor input. In addition, the development of high yielding rice strains in the Philippines put greater emphasis on non-labor inputs. Add to this the fall in world prices of Philippine commodities, the monopolization and increasing effective taxa-

tion of the agricultural sector, and the failure of the manufacturing sector to generate employment opportunities, and the result was increasing rural poverty and landlessness, as well as a dropping urban real wage. Poverty, the abuses of the military in local areas, and the ceding of large tracts of land to cronies or multinational exporters, greatly increased the strength of the NPA in the rural areas and the importance of agrarian reform as a domestic political and security issue.

Land reform held a central part in President Aquino's campaign and government platforms and is a responsibility set down in the constitution that was drafted in 1986. However, very little was done on agrarian reform in her first year in office until a protest by peasants outside Malacanang Palace in January 1987, in which police fired on and killed several protesters, brought the land reform issue immediately to the fore. An interagency group was created to develop a program and, after opposition within the president's office watered down several drafts, the Comprehensive Agrarian Reform Program (CARP) was released in late May. The program would start by completing the agrarian reform Marcos had started in rice and corn lands, followed by reform of government-owned and sequestered land, before going on to redistribution of sugar and coconut lands. Landlords would be paid the market value of their land, 10 percent in cash and the remainder in government bonds, while tenants would purchase the land over a thirty-year period.

Aquino did not implement the land reform program by executive decree when she had the opportunity, but instead passed the program on to Congress to determine the maximum area that current landlords could retain and the timing of the program. After much debate, the Philippine Congress passed the CARP, which President Aquino signed on 10 June 1988. The CARP extends over ten years. Current landowners are allowed to retain five hectares of land, plus three hectares for each child over fifteen years of age. The program is expected to cost P. 332 billion (\$15.8 billion) over its ten-year life, of which the bulk is for support services and infrastructure. Implementation is likely to be a difficult task. In addition, three-quarters of all privately owned agricultural land is in plots of less than ten hectares and likely to be excluded from CARP. While the effect of CARP on rural poverty and landlessness is likely to be modest, the political benefits from implementing the program could be huge.

### 8.2.3 Debt Renegotiation

Economic recovery and policy reforms were the first two challenges facing the new Philippine government; the remaining one was debt renegotiation. In contrast to relations with multilateral institutions, the change of government brought more politically charged and acrimonious relations with the Philippines' commercial bank creditors. The conflicts with the banks have centered

on the terms of Philippine rescheduling and debt service, and the status of loans made by the banks to the previous government.

Many of the loans made to the Marcos government had been to support public investment projects, or privately organized but government-favored projects, that were either of questionable viability or involved substantial misappropriation of funds. The suspicion of many in the new government was that the banks were cognizant of the uses to which the funds were being put and, therefore, bore some of the responsibility for questionable and now nonperforming loans made to the previous government. The calls for case-by-case evaluation of commercial bank loans, with repudiation in egregious cases, came almost immediately after the formation of the Aquino government and were most closely associated with the planning minister, Monsod. The finance minister, Ongpin, and the central bank governor, Fernandez, were opposed to any repudiation, and they won the argument within the government in 1986. President Aquino announced in mid-year that the Philippines would honor its foreign obligations, even in cases of questionable loans.

But the bitterest bone of contention between the Philippines and its creditor banks concerned the terms of the second rescheduling. Philippine negotiators were strongly influenced by the outcome of the bank negotiations with Mexico in September 1986 that had provided \$6 billion in new money, an interest spread over LIBOR of  $\frac{13}{16}$  percentage points, and a contingency fund of \$500 million if Mexican growth fell short of targets. Reacting to the Mexican outcome, the Philippines came to the negotiations in October with the demand that the Philippines be granted an interest rate spread of  $\frac{5}{8}$  over LIBOR.

The Philippine negotiators had two arguments for the reduced spread. The first was that the terms of the initial rescheduling had been deliberately harsh in order to punish the Marcos administration. The Aquino government, they argued, was committed to the reforms that the external creditors had long stressed and deserved a better program. The second argument was that the Philippines had successfully followed its adjustment program, eliminating its current account deficit, inflation, and external arrears. The Philippines did not need and was not asking for additional new money and, the negotiators argued, the country deserved better terms than Latin American debtors, who had been less successful in adjusting.

Most of the members of the bank advisory committee were willing to reduce the spreads of the original rescheduling agreement, but Citibank was initially adamant against any reduction in interest rates on rescheduled Philippine debt.<sup>26</sup> The negotiations with the bank advisory committee broke down in November over this issue, but resumed in January when Citibank agreed to the negotiating position of the other advisory committee banks.

The banks and the Philippine negotiators still remained divided over terms when the negotiations resumed. As a compromise measure, Ongpin proposed

that the banks receive a higher interest rate spread if they were willing to take the spread in the form of Philippine Investment Notes (PINs). These notes were dollar denominated and sold at discount, but their terms (six-year maturity, no interest payment) made their conversion into pesos for participation in the Philippine debt equity conversion scheme particularly attractive. The initial proposal was rejected by the advisory committee, but a revised version, making the acceptance of PINs optional on the part of the banks and guaranteeing a return of  $\frac{7}{8}$  percent, was accepted and formed a part of the second Philippine rescheduling.<sup>27</sup>

The Philippine negotiators and the bank advisory committee reached agreement on a multiyear rescheduling on 27 March 1987 (table 8.2). The agreement restructured \$3.6 billion in debt falling due between 1987 and 1992, as well as the \$5.9 billion previously restructured in the 1985 agreement. The amortization period on restructured debt was lengthened to seventeen years, with seven and one-half years' grace. The trade facility, which previously had been extended to mid-1987, was further extended to June 1991. There was no additional new money in the 1987 agreement. The \$925 million new money from the previous agreement was not rescheduled, but the facility was repriced along with the restructured amounts.

In the agreement, the Philippine negotiators settled for an interest rate spread that was slightly higher than the Mexicans had received in their negotiations in 1986, as well as an arrangement that allowed commercial banks to book higher earnings through the acceptance of PINs in lieu of

**Table 8.2** Philippine Debt Restructuring Agreements

Commercial Banks	Second Round, July 1987			First Round, May 1985		
	Amount (\$ billion)	Maturity (grace)	Interest Spread	Amount (\$ billion)	Maturity (grace)	Interest Spread
Previously restructured	5.88	17(7.5yrs)	$\frac{7}{8}$			
Debt falling due	3.58	17(7.5yrs)	$\frac{7}{8}$	5.88	10(5yrs)	$1\frac{5}{8}$
New money						
First restructuring			$\frac{7^a}{8}$	0.925	9(4yrs)	$1\frac{3}{4}$
Second	0.00					
Revolving trade credit	2.97		$\frac{3}{4}$	2.97		$1\frac{1}{4}$
Total	12.26			9.69		
Official Creditors	Amount		Amount		Period	
	\$ Billion	%	\$ Billion	%		
First round (20 December 1984)	0.725	100	0.258	60	Jan 85/June 86	
Second round (22 January 1987)	0.704	100	0.289	70	Jan 87/June 88	

Source: Central bank, Financial Plan Data Center.

<sup>a</sup>Repricing.

cash. The interest rate spread on restructured debt, the trade facility, and the 1985 new money agreement was seven-eighths over LIBOR.<sup>28</sup> The negotiators also agreed that if the Philippines were to later ask for new money, it would also seek to reschedule the 1985 new money facility, accepting a 1 percent spread. The agreement on the interest rate was, however, made retroactive to 1 January 1987.

The 1987 agreement significantly extended the period for amortizing principal on Philippine external debt and reduced the interest spread by three-quarters of a point. As a result, the debt service ratio for the Philippines was reduced from 48 percent before rescheduling in 1987 to 34 percent after. However, the failure of the negotiators to achieve an interest rate spread as low or lower than that received by the Mexicans was a stumbling block to approval of the agreement in the Philippine cabinet. The terms became a major issue in the Philippines when, shortly after the agreement was concluded, Argentina reached an agreement with its commercial creditors for an interest rate spread of  $\frac{13}{16}$ , the same as the Mexicans had received and  $\frac{1}{16}$  below that of the Philippines.

The results of the Argentine negotiations were greeted in the Philippines with dismay. Finance Minister Ongpin declared his intention to reopen the negotiations with the banks over the issue of the interest rate spread, but was eventually dissuaded by bank promises to take more interest in the form of PINs. The issue of the interest rate spread and the treatment of the Philippines relative to other LDC creditors remained the source of much domestic opposition to the 1987 agreement and a focal point of domestic opposition to Ongpin and Fernandez. But the argument over spreads was almost overshadowed by the reemergence of the Planters Products (PPI) issue.

Barclays Bank, a major PPI creditor and a member of the bank advisory committee, refused to sign the rescheduling agreement worked out in April, and renewed the demand that the Philippine government assume the \$57 million dollar external liability of the fertilizer company. The Philippine negotiators first tried to work out a compromise but in the end President Aquino agreed to assume PPI's obligations to rescue the agreement and preserve its retroactivity to January 1.

The PPI compromise and the whole debt rescheduling package became a major domestic political issue when, in an address to the newly assembled Philippine Congress in July, President Aquino charged that the banks had blackmailed the country into the agreement. In the months that followed, the external debt became the principal issue of the Philippine Senate. Bills were introduced to repudiate part of the debt and to limit debt service to a portion of foreign exchange receipts. Ongpin and Fernandez were called to testify before Congress to explain and justify the terms of the rescheduling agreement.

### 8.3 Economic Recovery

After more than two years of falling output, the Philippine economy began to recover in 1986. For the year as a whole, GNP growth was 2.0 percent, insufficient to prevent a third year of declining per capita income. In 1987, real output grew by almost 6 percent, which was below the official target of 6.5 percent but above most private forecasts.

The recovery in 1986 was led by exports and by increased government expenditure, the product of election spending early in the year and the subsequent agreement with the IMF to allow a larger budget deficit for 1986. Consumption demand was weak, as households rebuilt private savings, and investment dropped by an additional 15 percent to a level 60 percent below that of 1983. The strongest growth was in the agricultural sector. The increase in world prices for copra and coconut oil late in the year, the lifting of monopoly restrictions in the sector, and the end to the ban on copra exports resulted in a doubling of farmgate prices for coconuts. This greatly increased rural incomes and sales of commodities in rural areas. Export earnings rose by almost 5 percent during the year, with large volume increases of coconut products, fish, and prawns.

The recovery strengthened in 1987, with growth for the year estimated at 5.9 percent. Government expenditure rose more strongly than in 1986 through increases in public sector wages and a gearing up of the employment generation program in rural areas. Consumption demand rose by 5.5 percent with a recovery in the demand for durable goods. For the first time since 1983, there was growth in the industrial sector, where output increased by 8 percent, based largely on sales to the domestic market.

Two particularly welcome signs were the growth in exports and the recovery in domestic investment. Merchandise export earnings in 1987 totalled \$5.7 billion, up by 18 percent from 1986. Particularly strong growth came from electronics exports, as the world market recovered; garments, as the United States, Canada, and the EC increased their bilateral import quotas from the Philippines; and fresh fish, as agricultural producers in the sugar areas diversified into prawn production. Domestic investment grew 28 percent in 1987 after three successive years of sharp declines. Most of the increase in investment in 1987 came from domestic sources; foreign investment increased, but still remained below the dollar levels of 1981 through 1983.

The economic growth rate continued to accelerate in 1988, with growth estimated at 7.5 percent for the first three quarters, until typhoons late in the year reduced growth for 1988 as a whole to 6.9 percent. Investment provided the momentum in 1988, rising 26 percent in real terms. Foreign investment increased particularly rapidly, and foreign investment inflows increased by 120 percent in the first eight months of the year.

## 8.4 Prospects for the Philippines

Although the Philippines has made a strong start at economic recovery and policy reform, sustained economic growth is by no means assured. Difficult challenges for the Philippines remain, both political and economic. Much of the early attention of the government was directed to its own survival. The coup attempt organized by military officers in August 1987 was extremely serious and nearly succeeded in toppling the government.

In the period since the attempted coup, the situation improved considerably. The coup plotters were captured and jailed, and Aquino has taken actions, described above, to more closely bind the military to the civilian government. Although the threat of an overthrow has not disappeared, time is now on Aquino's side. Congress has been established and its members are now taking a more active role in the policy process. Political parties are reforming and jockeying with each other for position. The passage of time has served to focus ambition on the country's democratic institutions, and the next presidential election in 1992, which President Aquino has said she will not contest, is no longer so far away.

A less immediate, but ultimately more difficult challenge is that posed by the communist insurgency. The NPA has an estimated twenty to twenty-four thousand regular forces and constitutes the best military force in the country. In comparison, the Armed Forces of the Philippines has a combat strength of about fifty-five thousand, although many units suffer from poor training, support, and morale (Kessler 1988, 10). Rural inequality has nurtured the NPA, and the defeat of the guerrillas will require that the government carry out both a rural development program and a land reform program that address questions of economic inequality in the rural areas. Recent arrests of NPA leaders have weakened the movement, but its hold on many areas of the Philippines remains.

### 8.4.1 Economic Prospects

The challenge for the Philippines is the same as it has always been, achieving and sustaining rapid economic growth in the longer term. In the last part of the 1980s and the 1990s this will be a much more difficult task than in earlier decades, since the Philippines now has the burden of servicing a much larger external debt, and because obtaining external capital will be much harder than before. The necessity of achieving economic growth is particularly acute because of the momentum of population growth in the Philippines, at 2.5–2.7 percent per year, the highest in the region.

The post-1983 stabilization program in the Philippines cut per capita incomes, effectively wiping out the gains from the high growth, heavy foreign borrowing period. The current Philippine government has an ambitious target of 6.5 percent growth per year, which would return the

Philippines to 1983 income levels by 1992. Those outside the government, including the IMF, have adopted more modest, but still optimistic, projections of 6 percent real growth per year. Achieving even this rate of growth is by no means certain and will involve policy reform and perseverance, external cooperation, and some degree of luck.

The most obvious difficulties that the Philippines will face are the burden of servicing its external debt and limitations on its ability to borrow to achieve higher growth. The recent official and commercial bank reschedulings resulted in a significant reduction of scheduled amortization payments on external debt, as shown in table 8.3. However, projected interest payments still amount to 6 percent of national income, and the Philippines faces the burden of meeting the remaining amortization payments over the next five years.

The debt crisis affects the Philippines and other LDCs not just through the difficulty in shouldering the current debt burden; it also affects their ability to grow out from under that burden. The severely limited access to additional external finance is for most of these countries a constraint on the rate of investment and growth. Difficulties in financing an emerging current account deficit did not affect the Philippines immediately, primarily because of the unexpectedly large current account surplus in 1986. But the country has now reached a point where the external financing constraint is a real one, and additional external funds are necessary to sustain growth. The difficulty lies in the way in which the current account deficit was closed during the stabilization period.

**Table 8.3** Philippines Projected Debt Service, Government Projections  
(in billions of U.S. dollars)

	1987	1988	1989	1990	1991	1992
Debt service before rescheduling	4.40	5.44	4.59	5.22	5.43	5.17
Principal	2.27	3.13	2.27	2.80	2.85	2.49
Interest	2.13	2.31	2.32	2.41	2.58	2.68
Debt service after rescheduling	2.94	3.03	3.01	3.43	3.70	3.66
Principal	0.98	0.88	0.82	1.13	1.25	1.07
of which: IMF	0.31	0.16	0.18	0.33	0.31	0.15
Interest	1.96	2.15	2.18	2.30	2.45	2.58
Interest as % of GNP	6.0	6.0	5.5	5.2	5.0	4.7
Debt service ratio <sup>a</sup>						
Before rescheduling	49.4	56.9	44.7	46.5	44.4	38.1
After rescheduling	33.0	31.7	29.3	30.6	30.3	26.9
Memo Items:						
GNP (billion \$)	32.79	36.05	39.94	44.38	49.21	54.41
Exports goods and services	8.90	9.55	10.27	11.22	12.23	13.57

Source: Central bank.

Notes: Reschedulings include monetary and nonmonetary debt. Interest rescheduled by the Paris Club.

<sup>a</sup>Ratio of interest and principal payments to exports of goods and services.

Between 1983 and 1986, Philippine merchandise export earnings fell by 3 percent; thus, the entire closure of the current account deficit was due to a reduction in imports. After years of import substitution, Philippine imports are heavily concentrated in capital goods and imports of fuels and raw materials; only about 16 percent of the country's imports are made up of consumer goods (table 8.4).

The Philippines has been relatively successful in reducing its dependency on imported oil, substituting coal and other sources of domestic energy. But over a medium-term planning range, the demand for oil remains quite price inelastic, and the oil import bill is largely determined by swings in the world price of oil. Two of the other categories are closely tied to domestic economic activity—capital goods imports to the level of domestic investment and raw materials imports to industrial output. The behavior of each of these import components during the stabilization episode is shown in table 8.5. Capital goods imports as a percentage of GNP dropped rapidly, reflecting the sharp reduction in domestic fixed investment that took place during the period. Although the drop in the share of industrial output in GNP was not huge, those industries that depended on imported raw materials were particularly hard hit. Finally, slack domestic demand, plus the weakness in world oil prices, was responsible for the drop in oil imports. In contrast, consumer goods imports remained constant at about 5 percent of GNP, despite their being low priority imports.

**Table 8.4** Philippine Import Composition (percentage)

	1970-75	1976-80
Capital goods	35.7	29.1
Mineral Fuels	13.1	24.7
Nonoil raw materials	36.4	29.4
Consumer goods	14.7	16.9

Source: NEDA, *Philippine Statistical Yearbook*, 1987.

**Table 8.5** Philippine Imports by End-Use Category (percentage of GNP)

	1981	1982	1983	1984	1985	1986	1987
Capital goods	5.0	4.5	5.0	3.6	2.5	2.8	3.5
Nonoil raw materials	5.0	5.3	5.7	4.6	4.0	5.5	7.0
Mineral fuels	6.4	5.4	6.2	5.2	4.5	2.9	3.6
Consumer goods	4.3	4.4	5.0	5.8	4.9	5.4	5.5
Total	20.7	19.5	21.9	19.3	15.9	16.6	19.6
Memo Items (% of GNP):							
Exports	14.9	12.8	14.7	17.1	14.4	15.9	16.7
Fixed investment	26.1	25.7	25.1	20.1	15.1	13.0	14.0
Industrial output	36.8	36.5	36.4	35.4	33.6	32.6	32.6

Source: NEDA, *Philippine Statistical Yearbook*, 1987.

The fact that exports did not contribute to closing the current account deficit and that the reduction in imports took place in capital and intermediate goods explains why the current account balance has worsened sharply as the economy recovered. Even very large rates of growth of exports are unlikely to change this outcome. The reason for this is twofold. The categories of exports most likely to increase rapidly, electronics and garment exports, have imported input contents of 65–80 percent, and thus their expansion will lead to a partially offsetting rise in imports. Other categories of exports that are candidates for expansion will require substantial new investments, raising, at least for a time, imports of capital goods.

Nor is there likely to be much help from the service sector. The Philippines is unusual among the LDCs studied in this NBER research project in having substantial service export earnings. Despite net interest payments amounting to 6 percent of GNP, the country ran a small surplus on service account in 1985 and 1986.<sup>29</sup> Net service receipts are expected to diminish and become negative by 1992 as the growth of the economy raises service payments and because the prospect of weak growth in Middle Eastern countries limits expected earnings from construction and Filipino labor overseas.

As a result, medium-term projections for the Philippines all give current account deficits of 2–2.6 percent of GNP. Current account projections prepared by the Philippine government and the IMF are shown in table 8.6. The government projection assumes an economic growth rate of 6.5 percent per year between 1987 and 1992, and thus a more rapid rate of growth of imports and exports than does the IMF projection which assumes a domestic growth rate of 6 percent per year. Even with growth of export earnings of 13–14 percent per year, the current account deficit rises to 2.6 percent of GNP by the end of the forecast period.

The current account is not the only source of a need for external finance. In addition, the Philippines will have to either make or reschedule amortization payments on its external debt falling due, plus achieve a balance of payments surplus sufficient to allow reserves to grow along with imports. In some cases, financial commitments have already been identified, either in the form of loans that are being drawn down in tranches, commitments for external aid, or rescheduling that has already been agreed upon. But even with these three, there remains required finance that has not as yet been identified.

Projections of future financing requirements are less forecasts than they are planning exercises. One such projection for the Philippines is shown in table 8.7. For table 8.7 we use the current account projections of table 8.6, along with scheduled amortization payments on medium- and long-term external debt before agreed upon rescheduling. The overall balance of payments is assumed large enough to meet servicing requirements on

**Table 8.6** Philippine Current Account Projections, 1987-92 (in billions of U.S. dollars)<sup>a</sup>

	1987	1988	1989	1990	1991	1992	1987-92 <sup>b</sup>
<b>Philippine government</b>							
Trade balance	-1.0	-1.2	-1.4	-1.5	-1.5	-1.4	
Exports	5.7	6.8	7.7	8.7	9.8	11.2	14.3
Imports	-6.7	-8.0	-9.1	-10.2	-11.3	-12.6	13.3
Services and transfers	0.5	0.5	0.6	0.4	0.2	0.0	
Interest payments	-2.2	-2.4	-2.6	-2.8	-3.0	-3.1	
Current account	-0.5	-0.7	-0.9	-1.2	-1.2	-1.4	
Percent of GNP	-1.6	-2.0	-2.1	-2.6	-2.5	-2.6	
<b>IMF</b>							
Trade balance	-1.0	-1.1	-1.4	-1.5	-1.5	-1.4	
Exports	5.7	6.6	7.2	8.2	9.3	10.5	13.0
Imports	-6.7	-7.7	-8.6	-9.6	-10.8	-11.9	12.1
Services and transfers	0.5	0.5	0.4	0.2	0.0	0.0	
Interest payments	-2.2	-2.3	-2.3	-2.5	-2.7	-2.8	
Current account	-0.5	-0.5	-1.0	-1.2	-1.4	-1.4	
Percent of GNP	-1.6	-1.4	-2.5	-2.8	-3.0	-2.7	

Source: Philippine projections are from the central bank. IMF projections are from IMF (1988), p. 27, table 11.

<sup>a</sup>The central bank projections were prepared in November 1988, while the IMF projections were prepared in May 1988.

<sup>b</sup>Average growth rate.

**Table 8.7** Philippines Balance of Payments Finance Projections (in millions of U.S. dollars)

	1987	1988	1989	1990	1991	1992
Current account	-539	-743	-874	-1,151	-1,240	-1,402
Medium- & long-term loans	-1,214	-1,854	-778	-874	-1,019	-593
Inflow	981	687	1,684	1,512	1,565	1,620
Outflow <sup>a</sup>	2,195	2,541	2,462	2,386	2,584	2,213
Direct investment (net)	205	617	537	376	326	330
Other items (net) <sup>b</sup>	356	395	324	350	363	341
Net international reserves <sup>c</sup>	-265	134	-1,972	-662	-775	-660
Rescheduling	1,456	1,451	2,763	1,961	2,345	1,944
Paris Club	599	619	1,883	993	1,439	1,230
Commercial banks	857	832	880	968	906	714
Financing gap	0	0	1,293	446	925	1,230

Source: Central bank.

<sup>a</sup>Before rescheduling.

<sup>b</sup>Short-term capital, monetization of gold, revaluation, and errors and omissions.

<sup>c</sup>Minus sign indicates an increment.

monetary debt and to allow reserves to grow sufficiently to maintain a level equivalent to three months of imports. Current account financing makes up the largest component of the demand for additional finance, but not the only significant component; the financing gap in this projection, even after likely rescheduling by official (Paris Club) creditors, averages just under \$1 billion per year between 1989 and 1992.

In early 1989 the Philippines has just begun its third round of foreign debt rescheduling. An agreement has been reached with the IMF for a \$1.3 billion extended finance facility. As a part of this program the Philippines has agreed to reduce the national government's budget deficit through a reduction of subsidies and improved tax collections. The country has now begun negotiations with its official and commercial bank creditors. The Aquino government is asking for new money in this round and has proposed a figure of \$1.6 billion from the commercial banks. The commercial bank negotiations are likely to be difficult this time, just as they were in 1987. This is due not only to the increasing reluctance of commercial banks to provide new money in recent debt rescheduling, but also because the funding available to the Philippines from the Multilateral Assistance Initiative, Japanese foreign aid, and a possible renegotiation of the Military Bases Agreement with the United States are all uncertain. Finally, and ironically, the recent U.S. proposals on LDC debt made by Treasury Secretary Brady have increased the reluctance of commercial banks to provide additional funds before the status of their existing loans under the proposals are determined.<sup>30</sup> For its part, the Philippines has decided to force the issue by proposing a substantial increase in foreign exchange reserves in 1989, requiring an immediate need for new money.

#### 8.4.2 Export Prospects

Achieving sustained economic growth and at the same time limiting the current account deficit will require a substantial rise in Philippine exports. But financing of import growth is not the only role that exports will play in the Philippine recovery. Over the course of the stabilization period, both domestic investment rates and domestic saving rates declined. Restoring a higher rate of domestic investment will require a substantial increase in private and public saving rates in the Philippines, and this in turn will mean that the domestic market will grow less rapidly than output and income. To make all of this possible, exports must be a leading sector in Philippine economic expansion over the near to medium term. A final reason for the importance of exports in Philippine recovery and growth is the lack of success the country has had in achieving growth through production for the domestic market. Rates of employment growth and productivity growth in import-substituting industries have been distressingly low, and, at least for manufactured goods, export industries have provided the only source of dynamism in the last ten years.

As we have pointed out in previous chapters, the structure of Philippine exports changed dramatically in the 1970s. Traditional primary commodity exports—sugar, coconuts, logs and lumber, and minerals—were responsible for about 90 percent of export earnings in 1970, but only 50 percent by the end of the decade. Although declining in importance, these commodity exports still maintained substantial influence over total export revenue.

Slumping international commodity prices and declining Philippine export volumes of these primary commodities were responsible for a 15 percent decline in the dollar value of merchandise exports from 1981 to 1986, despite a continued growth in nontraditional export volumes and earnings. The influence of primary commodities in total Philippine exports has been greatly reduced to a current share of about one-quarter, although they still account for a larger share of net export earnings due to their higher domestic content.

For a variety of reasons, the prospects for sustained growth in Philippine primary export earnings are not good, although some near term growth can be expected as export taxes and the systems of monopoly regulation are removed. In the sugar industry, Philippine costs of production are estimated to be about 12 cents per pound, compared to a current world price of about 8 cents per pound. The Philippines benefitted up to 1984 from favorable long-term supply contracts it had negotiated when sugar prices were high. Since those contracts have expired, Philippine sugar exports have gone entirely to the United States under the U.S. sugar import quota, where sales prices have been about 18 cents per pound.<sup>31</sup> Thus even a substantial recovery of world sugar prices would not significantly increase Philippine export earnings. The prospects for future sales to the United States are also bleak; the U.S. has reduced overall sugar import levels substantially since quotas were reintroduced in 1982 and announced substantial reductions for 1988. For the Philippines this meant a reduction in quota from 240,000 tons in 1987 to 148,000 in 1988. The U.S. drought in 1988 brought an increase in sugar imports late in the year, but the longer term outlook remains unchanged.

In the past two decades the Philippines has increased its output of coconut products by extending the area of cultivation. Limits on cultivatable land have been reached, and increasing output now depends on increasing yields. Philippine coconut production has been hampered by low yields and aging trees, and total coconut production has fallen well below the peaks reached between 1978 and 1981. A program of replanting higher yield varieties would increase coconut output, but only after a gestation period of several years. In addition, since the Philippines accounts for about two-thirds of world exports of coconuts, and coconut products face competition from other vegetable oils, the prospects for increasing earnings through additional exports are quite low. Philippine mining exports have some prospect for growth if world copper prices remain high. Philippine production costs are slightly above world market averages, making the Philippines a marginal supplier although much of the country's mining capacity closed during the financial crisis. Gold is a byproduct of copper mining in the Philippines, and higher world gold prices have already raised mining earnings.

The prospects for expanding manufactured goods exports from the Philippines are brighter, although not assured. Philippine manufactured

goods exports are dominated by two industries, electronic components and garments, which together account for 72 percent of nontraditional exports and 53 percent of total exports. As a result of the protection given to Philippine domestic industry, both the electronics and the garment industries have developed as virtual enclaves, largely foreign owned, dependent upon imported inputs, and with few linkages to the Philippine economy other than the purchase of labor. Exports of electronics components declined with the slump in the world semiconductor market in 1985 and 1986, but increased strongly in 1987 and 1988. Philippine electronics exports are diversified, with the largest share going to other ASEAN countries, but future growth will depend on the growth of the world market and the continued maintenance of competitive real wages.

Philippine garment exports go almost exclusively to the United States, and thus the prospects for growth depend considerably on the degree of protection provided to the American industry. Despite this fact, Philippine garment exports have the potential for substantial growth. The Philippines has not been as aggressive as other countries in increasing its bilateral quotas, although it did receive higher U.S. and European quotas in 1987. More importantly, the Philippines has not taken full advantage of the quotas that it has. Quota utilization by the Philippines was the lowest among ASEAN countries in the 1980s and fell below 50 percent in 1984 and 1985.<sup>32</sup> Other factors work in favor of the Philippines in the longer term. The country has a small share of world exports of textiles and clothing, and both its product composition and export markets are highly concentrated, leaving open the possibility for diversification. Finally, after years of falling real wages, the Philippines now has a sizable cost advantage over other garment exporters in the region; only China has a productivity adjusted wage rate lower than that of the Philippines.<sup>33</sup>

The Philippines also has the opportunity to increase net export earnings from the garment industry, and perhaps also from the electronics industry, by developing backward linkages to the domestic economy as have other countries in the East Asian region. Successfully substituting domestic for foreign inputs will require that the Philippines carry through with its intention to reduce protection of the domestic industrial sector, and will also require that incentives for this type of indirect exporting match those for sourcing components externally. For example, subsectors of the domestic textile industry, in particular spinning, knitted fabric, denim, and sewing thread, appear to be competitive on world markets if the textile industry were to have access to inputs at world prices.<sup>34</sup>

Diversifying export industries may be the most successful strategy that the Philippines can pursue in increasing exports over the next five to ten years. The prospects for developing new industries are especially promising in the rural areas, in resource-based or labor-intensive industries. Already the Philippines has seen dramatic increases in exports of prawns to Japan and

other East Asian markets, and, before the land reform controversy erupted in mid-1987, producers in sugar growing areas were making substantial investments in prawn beds. Other possibilities for export crop diversification include coffee, cacao, pineapple and other fruits and vegetables, black pepper, and ramie. To a greater extent than growth from existing industries, growth through export diversification will require a more aggressive and sustained array of policy incentives. Diversification of exports from the rural areas will require complementary inputs of capital and rural infrastructure, a settlement of the land tenure issue, and maintenance of security and order in several of the rural areas. Both agricultural and export diversification will also require a shift in the balance of production incentives to encourage export activities, including the maintenance of an appropriately valued exchange rate.

#### 8.4.3 Financial Issues

In addition to overcoming the external financing constraint, achieving sustained economic growth in the Philippines will require solving several outstanding domestic financial sector problems. Financial markets in the Philippines have been buffeted by a series of financial crises, starting in 1981 and extending through the stabilization episode. The burden of credit stringency fell largely on the private sector, and among firms that survived there has been a significant deterioration in financial ratios. By one estimate, nearly half of all firms are facing, or are likely to face, significant financial difficulties.<sup>35</sup> These show up most often as problems in servicing existing loan obligations or difficulties in obtaining adequate working capital. Furthermore, until the financial ratios of these corporations improve, they are unlikely to be able to raise additional funds for investment or expansion as the Philippine economy recovers.

Carrying out programs of financial restructuring and recapitalization for the affected firms will be necessary for them to participate in an expansion of the Philippine economy, and given the number of firms involved, these restructuring programs may be required before significant growth can take place. This presents a number of problems for the Philippines, since there has been little experience with financial restructurings of this kind, and since the available expertise is quite limited. The necessary expertise may be available through foreign technical assistance, but the restructurings may also require legal and procedural changes to write down the assets of current creditors and recapitalize the firms.

The second and more general financial issue concerns the mobilization of domestic credit and the terms upon which it is made available to borrowers. The financial trauma of recent years in the Philippines has wiped out the progress that the Philippines made in financial deepening in the late 1970s and early 1980s. It has also erased what had been gradual progress toward extension of credit for longer terms; after several gyrations of interest rates,

banks have been reluctant to perform any term intermediation. Furthermore, although interest rates were freed from administrative control as part of the financial deregulation in the early 1980s, spreads between deposit and loan rates in the Philippines are very high, averaging 16 percentage points, compared to 3–4 percent for neighboring countries.<sup>36</sup> Much of the spread between deposit and loan rates results from the implicit taxation that the Philippines imposes on financial intermediation through high reserve requirements, the gross receipts tax, and the requirement that 25 percent of bank lending go to agriculture or eligible government securities. The high taxation of bank intermediation and the resulting large spreads are issues that the Philippine government is currently studying and may soon address.

To increase domestic savings made available through the financial system, and to lengthen the terms on which they are made available, the government must persuade the public that in the future there will be low and steady rates of inflation and safety in financial institutions. Monetary discipline and avoiding the use of central bank credit for fiscal purposes should achieve the first. The maintenance of the integrity of financial institutions will require closer and more effective supervision than the Philippine has so far known, more independent and professional management in many institutions, and perhaps larger and more diversified financial institutions. The long history that the Philippine has had of financial scandal and mismanagement must be laid to rest. These same prescriptions should encourage the development of both longer term lending and longer term deposits. In addition, increasing use of floating rate loans and the mobilization of assets from public and private insurance companies might also be used to encourage term credit.

#### 8.4.4 Sustaining Growth

The Aquino government has made considerable strides in its first two years in office. The most egregious monopolies have been eliminated, curbs have been placed on government interventions and particularistic application of law, the system of industrial incentives and protection has been reshaped in more neutral form, and reforms have been undertaken in the tax and financial systems. The Philippines has already begun to reap some of the benefits of these actions, particularly in the agricultural sector, in an external environment that has recently turned more favorable. However, further actions will need to be taken, and the Philippines will have to establish a reputation for consistency in policy in order to sustain an economic recovery.

Several more general challenges to policy are likely to appear in the coming years. The first, a waning of the momentum behind policy reform, is already beginning to occur. The window of opportunity presented by the indignation against the Marcos government has narrowed as the current government has become more established. This is most clearly seen in the flagging effort behind the government's privatization program. Resistance to privatization and to trade liberalization has also grown recently due to a

revival of Philippine nationalist sentiment and a reluctance to open the economy up to foreigners. The Philippine Congress has already passed several bills raising tariffs, although these have been vetoed by President Aquino.

Part of the problem for the Philippines is the ambiguity surrounding Marcos' administration and his departure from the Philippines. There has been a tendency to attribute the poor performance of the country's economy entirely to martial law and to cronyism, and to conclude that the end to the Marcos regime is sufficient to turn the economy around. There is also ambiguity as to the policy lessons that can be drawn from the martial law period. The rhetoric of the Marcos administration, and much of the public perception, was that this was an export promotion regime open to, and encouraging, foreign direct investment, and therefore that export promotion and international openness failed in the Philippines. In fact, as argued above, the Marcos government continued, and in many ways strengthened, the system of protection of the domestic manufacturing industry—the Philippines received the smallest gross inflows of foreign direct investment in the region and, at the same time, experienced substantial gross outflows, for the same reasons that domestic businessmen were moving their money overseas.

Finally, and ironically, Marcos was a parvenu, an outsider who challenged the traditional political system in the Philippines, but a challenger whose administration went badly wrong. The "People's Power Revolution" of February 1986 was in many ways a restoration of the former political order and institutions, with a strong possibility that the Philippines will resume the log-rolling patronage and obstruction to change that characterized the system before martial law.

There was no consensus among the opposition to the Marcos government on the outlines of a broad economic policy, other than the desire to be rid of the most invidious of the institutions of martial law, and the battle over policy direction will continue to go on within the government and the country. The arguments that are marshalled, and in many cases the outcomes, will be influenced by external policy, particularly that of the United States, the multilateral institutions, and the major creditor banks. The Philippines is a small country, and politics and policy are to a large extent personalized. These external actors were quite conscious of their role in supporting the technocrats under martial law, and ultimately placed too much trust in their ideology and their influence. Perhaps because of the disappointments that flowed from reliance on the technocrats, the external actors have not always been cognizant of their role in strengthening or weakening certain positions within the current Philippine government.

Nowhere has this been more apparent than in the 1987 commercial bank rescheduling exercise. Despite the fact that the Philippines had successfully stabilized the economy, deposed the man who was universally seen as the fundamental obstacle to reform, initiated substantial policy changes of the

type that had long been argued for, and was not asking for new money, the banks gave the Philippine negotiators an extraordinarily difficult time. Their heavy-handed treatment of the Planters Product issue, holding the entire agreement hostage to the government's assumption of the firm's liabilities, their failure to come down further on the interest rate spread, and their subsequent delivery of the Philippine interest rate demand to the Argentines, led to the discrediting of Jaime Ongpin and Jose Fernandez, the introduction of a raft of bills in the Congress on debt limitation or repudiation, and the departure from the government of Ongpin, who had been their strongest ally. Much has been said about the difference in the interest rate spread between the Philippine and the Argentine rescheduling, amounting to only \$5 million in annual interest payments for the Philippines. But the argument cuts both ways. The banks gained only \$5 million, having squandered the precedent in the Argentine negotiation, and lost Jaime Ongpin.

Corruption, or more generally, the generation and distribution of economic rents, has been an enduring feature of the Philippine economy. The Aquino government has not been immune to this charge. Two cabinet ministers were dismissed early in the administration after allegations that they were using their ministries for profit. Members of President Aquino's family, particularly her younger brother, have used their ties to her to increase their influence and wealth. There have been charges that the activities of the Presidential Commission on Good Government, set up to recover the assets of Marcos and his cronies, have diverted funds or transferred ownership to commission members or their relatives, and there have been numerous stories about low-level graft in the country even after the change in government.<sup>37</sup> Opposition politicians, particularly the former defense minister Enrile, have charged the government with developing a new set of cronies, as bad or worse than those of the Marcos government.

Such charges vastly overstate the case. Corruption in the current government is nowhere near the organized and extensive draining of the economy during the Marcos administration. The issue for the Philippines is not so much whether there is corruption, but on what scale corruption takes place, and how much damage it does to the operation of the economy. The key for fostering economic growth is to limit the scope of possible corruption and the amount of activity that can profitably be expended in seeking kickbacks, privilege, or other economic rents. In the Philippine case this means decentralizing and localizing corruption, so that it is not run on an almost economy-wide basis as it was under Marcos.<sup>38</sup> It also means changing the nature of the rules and limiting the scope for discretion, so that entrepreneurial energy is channeled into production and not the competition for rents.

This is the real importance of government reorganization and privatization in the Philippines. It is not so much an issue of whether the private sector is inherently better than the public sector, but more an issue of removing the

operation of industry and economic outcomes from those who control policy. Other policy reforms, import liberalization and the reform of the incentive structure, are important here because they shift the ground rules under which firms operate more toward neutrality and universality, and so direct energy into activities that are truly profitable for the society. So far, most attention has been placed on the pace of liberalization and privatization. More important are the terms on which these take place and the ground rules that are established.

Finally, to maintain the policy reforms that have been established and to achieve stability in economic policy, the solutions to the difficult economic problems that the country faces must be seen to be in Philippine hands. Economic ideology in the Philippines places the United States and U.S. influenced institutions in an ambiguous role. On one hand, the United States is seen as the source of Philippine problems—colonial dominance, exploitation by foreigners—but the United States is also viewed as the ultimate savior and guarantor of the Philippine situation. There has been a strong sense of *deus ex machina* in Philippine thinking about policy, a feeling that the United States would intervene to save them, when in fact the United States has treated the Philippines carelessly for most of postwar history. The Philippine desire for an external solution to its current difficulties was seen in the expectation, immediately following the February revolution, that the Philippines would be the recipient of a flood of foreign aid and direct investment, as well as the tremendous interest in a “Marshall Plan” for the Philippines when such a proposal was introduced in the U.S. Congress at the end of 1987. While a program will definitely go forward in what has now been renamed the Multilateral Assistance Initiative, the amount of additional funds will be far less than the \$10 billion originally suggested. It is also evident in the number of “solutions” to debt difficulties that have been proposed—the recovery of the Marcos fortune, the bargaining demand that the United States take over the Philippine debt in exchange for a new bases agreement, even the government-sponsored search for the “Yamashita treasure,” a vast fortune in gold rumored to have been buried by Japanese soldiers.

But the economic problems of the Philippines go beyond debt and beyond its relations with the United States and the rest of the outside world. If the Philippines is to achieve rates of economic growth that would allow it to rejoin the income ranks of its neighbors, it will require fundamental reorientation of domestic economic policy toward a more pragmatic, instrumental, and growth-oriented stance. Much intellectual effort has been expended in the search for the policy recipe that was responsible for the rapid growth of Japan and other East Asian countries, as if simply repeating the steps would duplicate their outcomes. But the success of these countries came primarily from their almost single-minded devotion to growth based on exports, and because they turned the outside world to their advantage.

In contrast, much of Philippine policy, and certainly much of Philippine nationalism, has been defensive in character, designed to insulate and protect the economy from the outside world and the dangers perceived there. What the Philippines needs to develop is a more aggressive and self-confident nationalism, one that manipulates and takes advantage of the opportunities that the outside world offers—an “inward culture and an outward economy” rather than the reverse (Intal 1987).

In fact, the situation in which the Philippines finds itself today is not so different from the situation characterizing many of the industrializing East Asian countries before their rapid growth took place, although none had the foreign indebtedness that the Philippines now shoulders. Japan, Hong Kong, and Singapore each had to deal with an unfavorable economic event that drastically limited their options and forced them to focus on export growth. For Taiwan and Korea it was the imminent reduction in U.S. aid which had supported domestic investment and large current account deficits that forced the shift in policies.

This is not to say that adversity always leads to success, or that the problems that the Philippines now faces are no more difficult than those faced by the East Asian exporters. Nor will Philippine prospects be unaffected by events and policies in the outside world. External markets that stay open to LDC exports, rather than markets that close down at the first sign of exporting success, will have a tremendous influence over whether economic policy in those less developed countries encourages production at world prices for world markets. A commercial bank lending process that recognizes and rewards successful policy reform and economic growth, rather than a concerted lending process that provides the minimum in financing that a country can get by with, will also greatly influence the incentives for persevering in reform. But whether the Philippines will ultimately be successful will be primarily determined by the actions that the country takes and the commitment that it can forge to policies that achieve growth.

## Notes

### Chapter 1

1. The tensions created by this migration are the primary force behind the Moslem insurgency which has troubled the Philippines for the past two decades.
2. Golay (1961, 202), Table 39.
3. On the problems of collection of Philippine taxes, see Golay (1961, 186–91). Tait, Gratz, and Eichengreen (1979) provide a comparison to other countries, and rank the Philippines near the bottom in tax effort.